

MiFID AND FRAGMENTATION: A CHALLENGE TO BE EMBRACED, NOT FEARED

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One of the most widely-discussed likely effects of the introduction of the Markets in Financial Instruments Directive (MiFID) has been that of fragmentation, both of liquidity and of data. This issue has often been cited as a potential downside of the new regime and it is not surprising that the onset of fundamental change is viewed with some trepidation. Nor is it surprising given the amount of work that financial institutions are having to do (in a relatively tight time-frame) to prepare for MiFID.

This article will look at the positive impact that MiFID will have on the European equity markets and the likely benefits of the subsequent fragmentation in the markets. It is worth noting that the industry is well positioned to face the challenges that MiFID brings due to the existence of advanced technology capabilities. If marshalled correctly, these should enable market participants to leverage MiFID in the way it was intended – by fostering growth and competition and providing investors with greater opportunities.

That MiFID will create an environment conducive to greater competition in trading is a given. Already, in the run-up to its November launch, alternative execution venues – including Turquoise, Equiduct, Chi-X and euroMillennium – have been flexing their muscles and are progressing in their plans, to varying degrees, to compete

with Europe's incumbent exchanges for trading business in the new environment. It is also likely that the proliferation of so-called "dark pools" of non-displayed liquidity that we have seen in the US market over the past years will spread to European markets.

By creating rules and transparency on systematic internalisation, MiFID gives investment banks an opportunity to offer execution services and a depth of book to rival the exchanges by capitalising on the fact that they can innovate and generate profit in ways that the traditional exchanges might find difficult. Systematic internalisers, unlike exchanges, will be able to have a view on trading strategies, and to create more appealing end-to-end products for the equity markets incorporating other asset types (such as derivatives).

The shape of the European markets post-MiFID will no doubt take some time to become clear. It will be interesting to see how certain issues play out – such as the way in which the tier one investment banks behind Turquoise will handle the platform's ability to compete with their own individual execution businesses. We could see a division of business across venues on the basis of trade size.

Without doubt, MiFID is unlikely to spell good news for all institutions

alike: second tier "generalist" investment banks without market-leading volumes in a particular business or a regional specialism may need to rethink their strategies in order to protect their franchises in the future.

Moreover, some fragmentation of liquidity does seem inevitable. Liquidity is sticky, but when it comes unstuck it can do so very quickly, as we have seen in the past with the flight of the Bund contract from Liffe to Eurex, and more recently in the U.S. with the flow of liquidity from Nasdaq to BATS.

The exchanges may experience a loss of liquidity in the face of a potentially more attractive trading environment with smart order-routing technology. This will give the upstarts a fighting chance of taking on the incumbents – despite the failure of initiatives such as TradePoint in the U.K. Smart order routing simplifies the traders' task of directing business to the most appropriate venue, based on a number of parameters, to achieve best execution.

How will this affect the European exchanges? The emergence of easily accessible alternative execution venues is likely to be a mixed blessing.

Galvanised by the threat of competition, they are now getting their houses in order in terms of latency, execution certainty and fees.



As for the users of execution services, these will have access to a vastly increased pool of products from across Europe, via a broader set of execution venues that have an incentive to provide the best price. The retail broker – which today has limited options when it comes to filling orders on behalf of investors – will have a far greater choice of pan-European products to offer its clients. Moreover, market forces will, over time, ensure that only the successful execution venues survive, and any unnecessary fragmentation of liquidity is eliminated.

If the impact of fragmentation of trading has its obvious benefits – the industry is also well positioned to assimilate the challenge of data fragmentation due to the technological capabilities offered by solution providers that will pave the way for subsequent de-fragmentation and re-consolidation.

Data is already fragmented across Europe's different exchanges. Under MiFID, it is probable that two or perhaps three providers will aggregate that data between them. There are likely to be at most two or three venues that will collectively provide 90 percent or more of the data, and each venue will offer about a third or a half of the information on any one ISIN. We expect this to lead to a less fragmented market for data than exists today.

Market data vendors can thus play the role of “de-fragmenters”, re-aggregating data from the different providers for delivery to end users. While finan-

cial institutions are currently having trouble preparing for the impact of MiFID and getting accustomed to viewing data in a different way, technology will allow them to overcome this hurdle.

The vast number of column inches dedicated to MiFID – not to mention extensive industry discussions over the challenges it poses – have whipped up fear of the directive, particularly with regard to fragmentation of liquidity and data. This sentiment should not be allowed to cloud the clear positive benefits that the markets will reap from MiFID. Regarding the threat posed to the exchanges' monopoly, MiFID has arguably had a very positive effect already: it has encouraged the exchanges to reduce trade reporting fees and to up the stakes on execution services. ■

About BOAT

The implementation of MiFID in November 2007 has provided the opportunity for a group of leading investment bank consortium members to establish a new pan-European platform that will benefit all participants actively involved in European capital markets.

BOAT will provide pre- and post-trade reporting services that will be compliant with the MiFID regulations. It is expected both to improve market transparency and to yield significant cost benefits owing to the economies of scale it will generate.